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A COMPARISON OF AFTER TAX INCOMES UNDER ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS

by

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Traditionally, farm businesses have been organized as sole proprietorships or partnerships. Recently, many farmers have considered seriously the corporate form of farm organization. During the past decade of rising farm income and property values, corporations have been suggested to some farmers as a tool for income tax management and particularly for transferring assets to the next generation. Two corporate forms available are the regular corporation (Subchapter C) and the pseudo corporation (Subchapter S).

Of course, income tax management is only one of several factors in selecting the form of business organization. Owner(s) should also analyze the impact of the form of business organization on (a) operating efficiency, (b) financing, (c) decision making structure, (d) entrance of another owner into the business, and (e) transfer of the business to the next generation. However, income tax effects are an important factor in determining the form of business organization used on farms.

The 1978 Tax Revenue Act changed the corporate tax rates, individual tax rates, and capital gains tax computation. It also upped the personal exemption amount (from \$750 to \$1000), contained technical corrections for the 1976 Tax Reform Act, and delayed the controversial carryover basis rules. Many of these provisions affect the farm business. In addition, the Ohio legislature (House Bill 1282) significantly changed worker's compensation premiums for Ohio farm corporations.

The objectives of this analysis are (1) to briefly summarize the income tax differences of the Subchapter S corporation, Subchapter C corporation, partnerships and sole proprietorships, (2) to compute the income tax liability for several representative farm situations under alternative forms of business organization, and (3) draw conclusions concerning relative incentives provided by the 1978 Tax Revenue Act and House Bill 1282 for farms to change to the corporate form.

SUMMARY OF TAX DIFFERENCES

1. Federal tax schedule

Sole proprietorships, partnerships, and subchapter S corporations are treated much the same by the Internal Revenue Service (IRS). Owners of each of these pay personal income taxes on their share of business income. The owner's share of annual income may be in the form of salaries paid by the business to the owner, earnings distributed to the owners, or undistributed earnings. When the business is growing, the owner(s) may have large portions of their earnings being undistributed as these earnings are used to repay debt, build up machinery and livestock inventories, or buy land.

The Subchapter C corporation may result in lower taxes in situations where earnings are not distributed to owners. Undistributed earnings of the Subchapter C corporation are taxed only once, and corporate rates are used. Prior to the 1978 changes, Subchapter C corporation rates were 20 percent on the first $25,000, 22 percent on the next $25,000 and 48 percent on earnings above $50,000 (Table 1). The 1978 legislation lowers these corporate rates dramatically for corporate taxable incomes of $100,000 or less. Individual income tax rates continue to range from 14 percent to 70 percent; however, the tax brackets are altered slightly by the 1978 legislation.[1] In short, the tax rate restructuring has given additional incentive for the small business to organize as a corporation.

When earnings are distributed to the Subchapter C corporation's

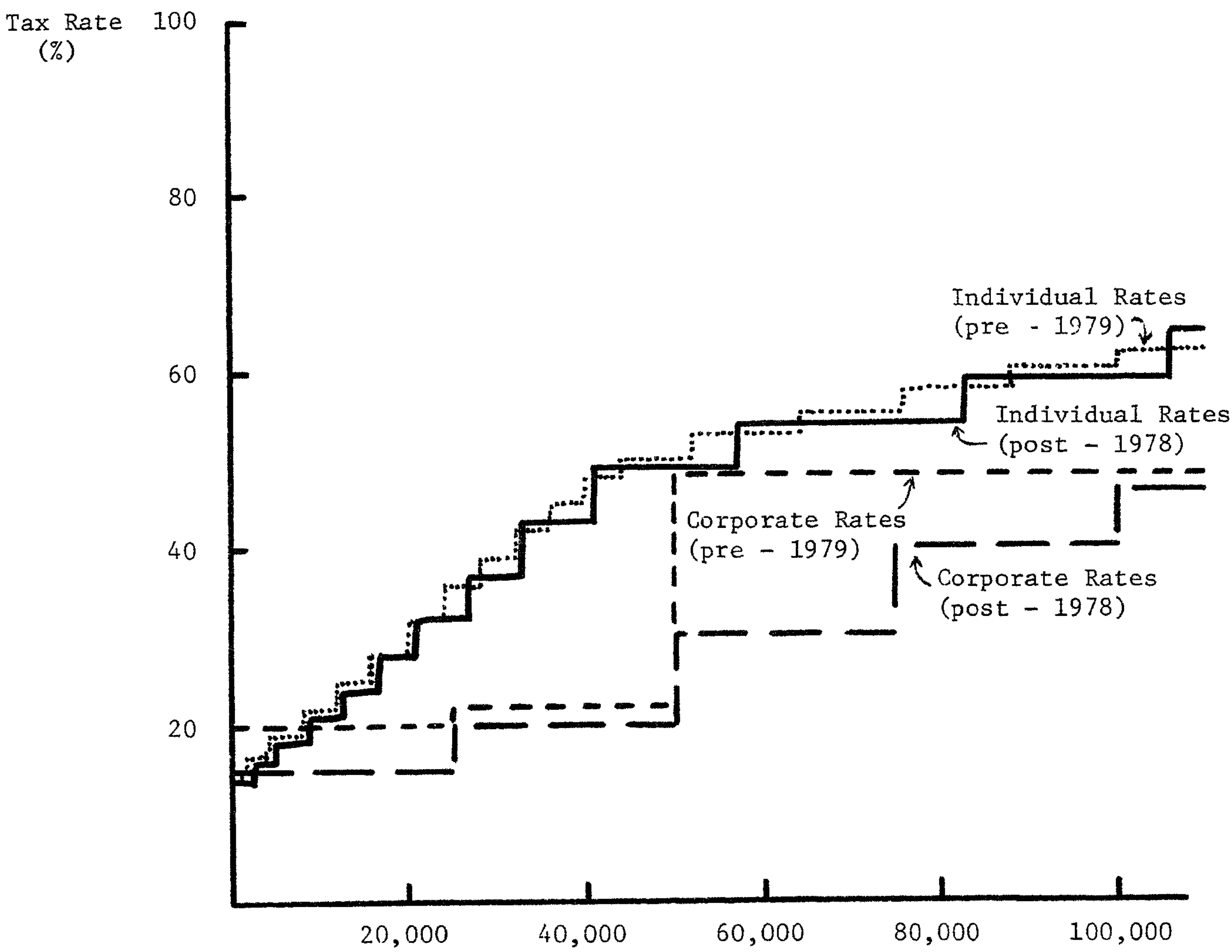

Table 1. Federal Corporate and Individual Marginal Tax Rates for Taxable Incomes of less than $110,000

owners, the form of the distribution is critical in determining tax savings. When dividends are distributed, they are taxed twice. They are taxed once as part of earnings on the Subchapter C corporation's return. Secondly, they are taxed as income to the owner. This double taxation of dividends usually causes the Subchapter C corporate form of ownership to have higher taxes than partnerships or sole proprietorships if substantial earnings are distributed as dividends.

2. Capital gains

The sole proprietorship, partnership, or Subchapter S corporation pass on to the owner his (her) share of net capital gains income. Prior to the 1978 legislation, capital gains were halved and included as part of ordinary income. Thus, the tax rate on capital gains was essentially half the taxpayers marginal tax rates. An alternative capital gains treatment was permitted, and it assured that the first $50,000 of capital gains was taxed at a maximum rate of 25 percent and that above $50,000 was taxed at a maximum rate of 35 percent. After the 1978 legislation, only 40 percent of the capital gains are included as part of ordinary income.[2] The alternative tax computation for individuals is cancelled for 1979 and thereafter.[3]

The Subchapter C corporation continues to combine all capital gains with ordinary income to determine taxable income, and the capital gains tax rate is essentially the marginal corporate rate. An alternative capital gains treatment limits the net capital gains of corporations to a 28 percent rate (30 percent for years prior to 1979).[4] Thus, capital gains are generally subject to higher rates for the Subchapter C corporation than for the sole proprietorship, partnership, or Subchapter S corporation.

3. Capital losses

The individual taxpayer, having a sole proprietorship or a partnership share, can deduct net capital losses in the year they occur. The rules permit only 50 percent of net long term capital losses to be charged off against ordinary income. Also, net capital loss deductions are limited to the smaller of $3,000 or taxable income for the year. If net capital losses exceed this limitation, they may be carried over to the following years until completely absorbed.

With the Subchapter S corporation, net capital losses are not passed on to shareholders in the year they occur. Excess capital losses over gains may only be used by the corporation as a capital loss carryover.

For the Subchapter C corporation, capital losses can be decucted only to the extent of capital gains. Any loss not absorbed can be carried back 3 years and, if not completely absorbed, is carried forward up to 5 suceeding years.

4. Minimum tax on tax preferences

Many tax preference items, such as capital gains, accelerated depreciation on real property, and depletion, were subject to a minimum tax prior to the 1978 legislation. In essence, the tax laws assured that taxpayers making use of these deductions did not reduce taxes below some minimum.

For the proprietor, partner, or Subchapter S shareholder, all tax preference items were totalled. Along with other preference items, one half of the net capital gains was included. The total tax preference items were reduced by the greater of (a) $10,000 or (b) one-half the regular tax liability less tax credits. These net tax preferences were subjected to a flat 15 percent tax rate. For the Subchapter C corporation, the minimum tax computation was similar except the tax preference portion of capital gains was often non existent.

The 1978 legislation retains a minimum tax on tax preferences. However, individual capital gains are not tax preferences for the minimum tax.

Alternative minimum tax is a new concept for tax payers other than Subchapter C corporations in 1979. These taxpayers must compute regular tax liability and increase it by the amount of any regular minimum tax. This sum must be compared with the tax computed under the alternative minimum tax formula, and the tax payer pays the greater amount. The alternative minimum tax applies to adjusted itemized deductions and capital gains. If these items total between \$20,000 and \$60,000 the alternative minimum tax rate is 10 percent; between \$60,000 and \$100,000, the rate is 20 percent; and over \$100,000, the rate is 25 percent.[5]

5. Net operating losses

Operating losses from the partnership or sole proprietorship offset other income for owner(s). If this combination results in a net loss for the year, the loss can be carried back three years and forward seven years. Also, the Subchapter S corporation allows operating losses to be passed through to the owners to offset other income and to be carried over to other years. However, the Subchapter C corporation operating loss can not be passed through to the owner althrough they can be carried over to offset corporate income in other years.

6. Social security tax

Social security taxes favor a sole proprietorship or partnership. The sole proprietor or partner pays 8.1 percent of the first \$22,900 (\$25,900 in 1980) on earned income.

The corporate form (Subchapter S or C) requires both the corporation and employee to each pay 6.13 percent (a total of 12.26 percent) on the first $22,900 ($25,900 in 1980) of owner-employee salary. Slightly offsetting this increased social security taxation for corporations is the fact that the corporation's 6.13 percent contribution is a deductible expense for the business.

7. Accident and health plans

Agricultural employees have been brought under worker's compensation systems in many states including Ohio. These state insurance systems free the employer from paying benefits to disabled employees or those having job related illnesses. Rates differ from state to state for this insurance. In Ohio, the 1978-79 rate for general farm labor is 9.67 percent on the first $15,600 of salaries with the rate varying depending on the type of labor performed.

Prior to 1979, the Ohio Subchapter S or C farm corporation paid these rates on owner-employee salaries. The sole proprietor or partner was not required to pay the premiums on his (her) own wages. Of course, any of the organizational forms would be subject to workmen's compensation for hired labor. Beginning in 1979, the Ohio legislature exempts officers of Ohio Subchapter S or C farm corporations from paying premiums on his (her) own wages.[6]

This exemption could significantly enhance the corporate form for farm businesses since outlays for worker's compensation might decline by almost $1,500 per owner. Of course, worker's compensation benefits would be lost as well.

8. State income tax

Typically, the sole proprietor's, partner's or Subchapter S shareholder's share of business income (distributed or undistributed) is subject to personal state income taxes. Only the Subchapter C shareholder's distributed earnings (salary, interest, or dividends) are taxed by personal state income taxes.

In Ohio corporations (Subchapter S or C) pay the greater of a state franchise tax or a state income tax. The state franchise tax is equal to 5 mills of the net worth. The income tax is 4 percent on the first $25,000 of corporate income and 8 percent on the excess.

9. Retirement plans

Tax deductible retirement plan contributions vary by business organization form. The Keough plan and individual retirement account are available to the self-employed partner or sole proprietor. The Keough plan allows tax deferred annual contributions to a qualified plan. Limits on these contributions are the smaller of $7,500 or 15 percent of earned income. All employees must be covered if the owner(s) are covered by a Keough plan. The individual retirement account is available to those who do not participate in another qualified retirement plan. It permits annual deductions up to the lesser of $1,500 or 15 percent of earned income. For the Subchapter C corporate owner-employee deductible retirement plan, contributions may exceed those of the sole proprietor, partner, or Subchapter S corporate owner-employee. Using an employee pension trust or annuity, the Subchapter C corporation may deduct the amount necessary to satisfy the minimum funding requirement of the qualified plan. Using a stock bonus or profit sharing plan, the employer can deduct contributions up to 15 percent of employee compensation.

ANALYSIS OF REPRESENTATIVE FARM BUSINESS SITUATIONS

The taxes of several representative farm situations are examined under alternative business organization forms. First, federal and state income taxes for one case farm are computed in detail. Second, total income taxes for a range of farm situations are estimated. Throughout the analysis, Ohio state income taxes are used. Corporate state rates are higher in Ohio than in most states, and the analysis biases the results in favor of non corporate ownership. Thus, the results tend to underestimate the incentives for most U.S. farms to use the corporate ownership form.

1. Taxes for a case farm

In outlining the state and federal taxes for one case situation, a two owner business is assumed. Annual net farm income is $80,000, all of which is taxed as ordinary income. Four personal exemptions are claimed by each owner, and the standard deduction is used by each. The owners have equal ownership in the business, and they each receive an annual distribution of one half of the net farm income. It is assumed that these distributions are in the form of wages if the business is incorporated. No retirement plans are funded, and worker's compensation premiums are not paid on corporate owner-employee wages.

Table 1 contains the tax liabilities for this particular case, and points out some of the tax implications of alternative business forms. First, notice the federal and state personal income taxes paid by owners. The owners pay nearly the same amount of personal and state income taxes whether they are partners or Subchapter S shareholders. Next, social

Table 1. Federal and State Tax Liabilities Under Three Methods of Organization for a Two Owner Case Farm, 1979[a]

	Form of Organization		
	Subchap. C Corp.	Sole Owner or Partner	Subchap. S Corp.
I. Owner Employees Personal and State Income Tax			
Owner 1			
Federal Income Tax	2265	8458	7900
State Income Tax	155	720	675
Social Security	1226	1855	1226
Owner 2			
Federal Income Tax	2265	8458	7900
State Income Tax	155	720	675
Social Security	1226	1855	1226
Subtotal Owner Costs	7292	22066	19569
II. Corporations Taxes and Costs			
Federal Income Tax	6359		
State Income or Franchise Tax	2004		2004
Social Security Payments	2452		2452
Subtotal Corporation Cost	10815		4456
Total Annual Tax Liability	18107	22066	24057

[a]Assumptions Used

1.	Number of owners	2
2.	Annual net farm income	$80,000
3.	Capital gain income	0
4.	Personal exemptions per owner	$ 4,000
5.	Personal deductions per owner	$ 3,400
6.	Annual salary per owner if incorporated	$20,000
7.	Annual dividends per owner if incorporated	0
8.	Retirement plan contributions	$ 0
9.	Ohio state income tax laws and workmen's compensation premiums are assumed.	

security taxes paid by a partner is different than that paid by the corporation and owner employee (both the corporation and employee pay $1,226 on each owner's salary). Also, notice the state income tax ($2,004) paid by the two corporate forms of business. This is calculated according to Ohio rates and would differ from state to state. Last, the personal tax liability of Subchapter C corporate owner employees is lessened, and the liability of the corporation is increased. When the total tax and social security outlays are compared, the Subchapter C corporation is preferred with taxes of $18,107 compared to taxes of $22,076 for the partnership, and $24,057 for the Subchapter S corporation.

After tax income would improve by switching business organization from a partnership to a Subchapter C corporation. After tax income is improved by 3.2 percent [(80,000 - 18,107)/(80,000 - 22,066)] for the case situation.

While federal income tax laws treat partnerships and Subchapter S corporations similarly, state tax laws and the federal social security system view the Subchapter S corporation differently than the partnership or sole proprietorship. Like the Subchapter C corporation, the Subchapter S corporation may be subject to state corporation tax and employee social security taxes. Thus, the Subchapter S corporation usually has higher income taxes than the partnership (both organization forms pay similar federal income taxes, but the Subchapter S corporation bears additional costs for Ohio corporation tax and added social security taxes).

Due to these tax disadvantages of the Subchapter S corporation, the remaining analysis ignores the Subchapter S corporation since it usually would not be the preferred organizational form for income tax purposes in those businesses with positive taxable incomes.

2. Analysis of a range of farm situations

One, two, and three owner businesses are included in the analysis. Annual net farm incomes are varied from $10,000 to $50,000 per owner, and total taxes are calculated under the Subchapter C corporate form and the sole proprietorship or partnership form. For each unique situation of number of owners and net farm income, a measure of the advantage (or disadvantage) of corporate ownership is calculated. This analysis is done for the 1977 tax year and for the 1979 tax year in order to determine the incentives provided by the 1978 Tax Revenue Act and House Bill 1282 for farms to change to corporate forms of organization.

The results for the one owner business are summarized in Table 2. Prior to the 1978 legislation, the sole proprietorship had to have a net farm income exceeding $30,000 before the corporate form saved taxes. The 1978 legislation reduces this breakeven point to a net farm income of approximately $15,000. The incentive to switch to the corporate form increases dramatically as income increases above $15,000. In 1977, the sole proprietorship earnings $50,000 annually was forfeiting over 10 percent of its after tax income to remain a sole proprietorship. In 1979, the same single owner is forfeiting 12.7 percent of its after tax income to remain a sole proprietorship.

Results for two and three owner business (Tables 3 and 4) provide similar generalizations. A net farm income of about $15,000 per owner is needed before the corporate form increases after tax earnings for the two owner business. For the two and three owner business with high incomes, the 1978 Tax Revenue Act and House Bill 1282 provide added incentives to incorporate.

Of these two recent changes in legislation, Ohio House Bill 1282

Table 2. Percent Change in Annual After Tax Income by Changing from a Sole Proprietorship to a Subchapter C Corporation, Before and After 1978 Tax Legislation[a]

Annual Net Farm Income[b]	Pre - 1978 Tax Legislation[c]	Post - 1978 Tax Legislation: 1978 Tax Revenue Act	Post - 1978 Tax Legislation: 1978 Tax Revenue Act plus H.B. 1282
	(% change in after tax income)		
10,000	-7.6	-9.4	-4.0
15,000	-3.4	-5.6	1.2
20,000	-3.0	-1.5	3.2
25,000	-2.7	-0.5	4.5
30,000	-1.5	0.4	5.4
35,000	1.0	2.0	6.6
40,000	4.2	4.0	8.1
45,000	7.2	5.2	8.8
50,000	10.3	9.2	12.7

[a] Ohio state income tax laws and worker's compensation premiums are assumed. Tax liabilities would differ slightly between states. Taxes considered included the federal personal income tax, federal corporate income tax, federal social security tax, state worker's compensation tax, state personal income tax, and state corporation tax.

[b] The following assumptions are used: all of the net income is taxed as ordinary income, four personal exemptions, standard deduction, 50 percent of net farm income is distributed to owners as wages, and no retirement plan or fringe benefits are deductible to the corporation.

[c] 1977 tax structure is used.

Table 3. Percent change in Annual After Tax Income by Changing from a Two Owner Partnership to a Subchapter C Corporation, Before and After 1978 Tax Legislation[a]

Annual Net Farm Income[b]	Pre - 1978 Tax Legislation[c]	Post - 1978 Tax Legislation	
		1978 Tax Revenue Act	1978 Tax Revenue Act plus H.B. 1282
	(% change in after tax income)		
20,000	-6.6	-8.4	-4.0
30,000	-3.4	-3.3	1.2
40,000	-3.0	-1.5	3.2
50,000	-2.7	-0.3	4.5
60,000	-1.6	0.4	5.0
70,000	0.6	1.5	5.7
80,000	3.3	3.1	6.8
90,000	6.0	3.9	7.2
100,000	8.9	7.6	10.8

[a]Ohio state income tax laws and worker's compensation premiums are assumed. Tax liabilities would differ slightly between states. Taxes considered included the federal personal income tax, federal corporate income tax, federal social security tax, state worker's compensation tax, state personal income tax, and state corporation tax.

[b]The following assumptions are used: all of the net income is taxed as ordinary income, four personal exemptions, standard deduction, 50 percent of net farm income is distributed to owners as wages, and no retirement plan or fringe benefits are deductible to the corporation.

[c]1977 tax structure is used.

Table 4. Percent change in Annual After Tax Income by Changing from a Three Owner Partnership to a Subchapter C Corporation, Before and After 1978 Tax Legislation[a]

Annual Net Farm Income[b]	Pre - 1978 Tax Legislation[c]	Post - 1978 Tax Legislation: 1978 Tax Revenue Act	Post - 1978 Tax Legislation: 1978 Tax Revenue Act plus H.B. 1282
	(% change in after tax income)		
30,000	-6.6	-8.4	-4.0
45,000	-3.4	-3.3	1.2
60,000	-3.0	-1.5	2.9
75,000	-3.2	-1.0	3.5
90,000	-2.5	0.7	3.9
105,000	-0.3	0.5	4.7
120,000	2.6	2.2	5.6
135,000	3.6	2.5	5.4
150,000	4.7	5.7	8.5

[a]Ohio state income tax laws and worker's compensation premiums are assumed. Tax liabilities would differ slightly between states. Taxes considered included the federal personal income tax, federal corporate income tax, federal social security tax, state worker's compensation tax, state personal income tax, and state corporation tax.

[b]The following assumptions are used: all of the net income is taxed as ordinary income, four personal exemptions, standard deduction, 50 percent of net farm income is distributed to owners as wages, and no retirement plan or fringe benefits are deductivle to the corporation.

[c]1977 tax structure is used.

provides the great incentives to incorporate. For example, consider the one owner business (Table 2). The 1978 Tax Revenue Act reduces the breakeven point from about $30,000 to about $25,000 net farm income. However, House Bill 1282 further reduces the breakeven point from about $25,000 to about $15,000 for this business.

These results do not mean that all farmers having net farm incomes greater than $15,000 per owner would save taxes by incorporating their businesses. These results are generalizations from several simplified case situations. An analysis of each firm's situation needs to be made prior to selecting an organizational form.

CONCLUSIONS

Advantages gained by incorporating the family business may include easing property transfer between generations, income tax savings, facilitating the entrance of others into the business, operating efficiencies, and financial efficiencies. This analysis considers only income taxes and does not include some other costs of incorporation such as attorney's fees, filing fees, or accountant's fees faced by the business when incorporating. These costs should not be overlooked.

Corporate tax advantages are greatest when large amounts of earnings are retained in the business, allowing the business to grow. When distributions are made from the corporation, tax advantages are gained when these distributions are in the form of salaries or other deductible expenses (e.g., interest) rather than dividends. Corporations are least beneficial when distributions are in the form of dividends. Dividends lead to double taxation (corporate and individual level) on some of the business earnings.

If the business if generating net farm income of more than $15,000 per owner, the corporate form of ownership may be preferable from the income tax management perspective. Regardless of the level of business income, distribution of a high percentage of business income to the owners as salaries will result in few tax savings being gained by the Subchapter C corporation.

The 1978 Tax Revenue Act and House Bill 1282 have dramatically increased the incentives for incorporating the business. The income levels where tax savings are gained from incorporation have been reduced from about $30,000 per owner to about $15,000 per owner.

FOOTNOTES

[1]Section 101, Revenue Act of 1978 (1978 RA).

[2]Section 402, 1978 RA.

[3]Section 401, 1978 RA.

[4]Section 403, 1978 RA.

[5]Section 421, 1978 RA.

[6]Ohio House Bill 1282.